Enhancing Housing Affordability with a Neutral Tax Shift

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This proposed property tax shift should improve resource allocations as well as making housing more affordable if implemented regionally. The shift is a reduction of the tax rate on improvements or buildings and an increase of the tax rate on land.

We use the example of an actual case in Virginia: Appraisals: Building (house): $182,000, Land: ¼ acre: $53,000.

Combined taxable value: $235,000. Existing tax Rate: 1.0% on both the lot and the house. Total Tax: $2,350 per annum.

In order to assess the price effect of taxes we must first know the annual benefit derived by a property in terms of its implied rental income. We find the impact on property prices from increasing the land tax from 1% to 3%.

Next we posit a .5% reduction in the tax rate on the appraised value of the improvement (house). The outcome will be an incentive to employ the site aspect of property more efficiently as well as stimulate housing construction without significant impacts generally on property owner wealth nor on jurisdictional tax revenues. A normal return on investment is assumed to be 5%.

We assume the current pricing of the land reflects a 5% implicit (usage and any anticipated gains from appreciation) return or rental of $2,650/yr. With the 1% tax of $530, there is then an implicit total return of $3,180 before taxes, or 6%.

Specifically, the $53,000 lot initially must have a 6% return with a 1% tax–6% of $53,000 is $3,180, with a net return of $2,650, which is 5% of the $53,000 investment. (The capitalized value of the parcel with no tax would be more. If it is currently earning 5% after a 1% tax then with no tax it should be valued to return the $3,180 as 5% of its value. Hence, it would be $63,600. In other words with a penalty of 1% of the price, in order to get a 5% return the value must drop from $63,600 to $53,000. This is a drop of 16 2/3 %, the current price effect of the 1% tax.)

For the first year we have an ongoing 1% tax. If we change to a 3% land tax starting the second year then, after the tax increase occurs for the return to remain at a net 5% the $53,000

investment must drop in value so that a new investor can yet derive a net 5% from ownership of the property. We assume a sale and reappraisal each year.

With a 3% tax we would end up with the constant $3,180 return or rental amounting to 8% (i.e. .05+.03) of the new lower lot price P. Then $3,180=.08P so P= $3,180/.08=$39,750. This is a 25% drop from the original price. For a comparable vacant or underutilized lot the new tax rate would have a considerable impact.

A .5% tax on the house (the building portion of the property only) plus 5% net return requires a 5.5% return. Given the rental was 6% of $182,000 or $10.920 this is 5.5% of $198,545, the new price of the house–a 9% increase.

The tax for the house is .5% of $198,545 = $992.7. The tax on the lot is 3% of $39,750 = $1,192.5. The total tax is $2,185, just $165 under the original combined tax of $2,350. The combined value of the lot and house is $238,295, a $4295 gain of over 1 %.

With a 9% boost to the capitalized value of such improvements, a stimulus to construction should occur. But also more idle lots would be put on the market by owners not willing to pay the 25% increase in tax. Hence, the outcome would impact land values somewhat more than calculated above. An even larger tax rate on land values would produce a concern for the up-taxing of land. A tax approaching the full rental value of land would eliminate the pricing of land altogether, an untenable result for efficient market allocation of property.

A moderate tax shift policy would allow for orderly transitional adjustments over a number of years as the new data becomes known obviating the need to calculate a final resting point for proposed changes. It would seem that up to a 3% land tax would not be too disruptive especially if the net tax on both the land and the improvements remains below its initial amount, as was the case in our illustration.

What is known at the outset however, is that the direction of change results in net beneficial outcomes that make housing more affordable while also reducing sprawl and increasing urban infilling. See details for the two tier tax policy for Harrisburg Pa.: https://blogs.ubc.ca/rosonluo/2013/04/08/land-value-tax-policy-in-harrisburg-pa-u-s-densification-policy/